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No. 87-1168

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

In this case, a relatively small corporation was merged into a subsidiary of a large publicly-owned corporation, and the sole shareholder of the acquired corporation received in return both cash and shares of the stock of the publicly-owned corporation. The question presented is whether that payment of cash had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (Pet. App. 15a-39a) is reported at 86 T.C. 138.

JURISDICTION

The judgment of the court of appeals (Pet. App. 40a) was entered on September 4, 1987. On November 25, 1987, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 2, 1988. On December 17, 1987, the Chief Justice further extended the time for filing a petition for a writ of certiorari to and including January 11, 1988. The petition was filed on that date and was granted on March 7, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 301, 302, 316, 317, 354, and 356 of the Internal Revenue Code of 1954 (26 U.S.C.), as amended, are set forth in the Appendix, *infra*, 1a-6a.

STATEMENT

1. For some 15 years prior to April 1979, respondent Donald E. Clark[1] had been the president of Basin Surveys, Inc. (Basin), a West Virginia corporation that furnished radiation, nuclear, and electronic open-hole logging services to the petroleum industry, and he then owned all of its outstanding 58 shares of stock. N.L. Industries, Inc. (NL) was then a publicly-held New Jersey corporation engaged in manufacturing and supplying petroleum equipment and services, chemicals and metals. NL had outstanding approximately 32,533,000 shares of a single class of common stock and 500,000 shares of preferred stock. That stock was publicly traded on the New York and Pacific Stock Exchanges. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL. Pet. App. 16a; J.A. 26-27.

In 1978, NL initiated discussions with respondent concerning the possible acquisition of Basin. After several months of negotiations, in March 1979 NL offered respondent alternative terms for the acquisition of Basin: (1) 425,000 shares of NL common stock without cash; or (2) 300,000 shares of NL common stock and $3,250,000 in cash. Respondent decided in favor of the latter alternative. Pet. App. 16a.[2]

[1] Respondent Peggy S. Clark is a party herein only because she filed a joint federal income tax return for the calendar year 1979 with her husband, respondent Donald E. Clark. References to "respondent" in the singular will be to Donald E. Clark.

[2] In the Tax Court, respondent's attorney testified (and it was agreed that, if called, respondent would testify to the same effect (J.A. 60)) that, at the meeting at which NL made its alternative offers, respondent had requested the NL representatives to leave the room so that he could discuss the alternatives with his attorney. In that discussion, the factors that led to a tentative choice of the latter alternative were that respondent's "whole livelihood was tied up in his company," and that an all-stock deal would involve the risk of serious loss if something happened to NL. Moreover, the stock of NL that would be received would not be registered stock, but would be restricted letter stock, which would mean, under Securities and Exchange Commission rules, that respondent would have to hold the stock for two years before he could sell it and realize full value. And, in view of respondent's complete involvement with his company, that, in turn, would have meant that he could not immediately pay his outstanding bills. J.A. 56-59.

On April 3, 1979, an agreement and plan of merger was executed by Basin, NLAC, NL, and respondent. The plan provided that, on April 18, 1979, Basin would merge with and into NLAC, which would change its name to Basin Surveys, Inc., and that respondent would receive, with respect to each of the 58 shares of Basin that he owned, 5,172.4137 shares of NL common stock and $56,034.482 cash. The merger took place as planned. Respondent received a total of 300,000 shares of NL common stock and $3,250,000 in cash, and he entered into an employment agreement with the new Basin Surveys, Inc., for three years and an agreement not to compete for five years. Respondent and the Internal Revenue Service (IRS) stipulated that the merger of Basin into NLAC was effected pursuant to, and qualified as, a reorganization as defined in Section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code.[3] Pet. App. 16a-17a; J.A. 27-28.

2. Section 356(a)(1) of the Code provides that, if cash or other property (commonly known as "boot") is received in the course of what would otherwise be a tax-free, stock-for-stock reorganization (see I.R.C. § 354(a)(1)), the re-

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

cipient must recognize his gain on the transaction up to the value of that cash or other property received. Accordingly, in their joint federal income tax return for 1979, respondents reported the cash received in the merger as taxable gain.[4] They characterized this amount as long-term capital gain. Section 356(a)(2) of the Code, however, requires that, if the exchange "has the effect of the distribution of a dividend," the distributee must treat the amount of the gain as a dividend to the extent of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. Applying this section, the Commissioner on audit determined that $2,319,611 of the reported gain (which was the amount of the accumulated earnings and profits of Basin at the time of the merger (J.A. 29)) should be treated as a dividend. Because that amount would then be taxable as ordinary income, rather than as capital gain, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979 (J.A. 11-22).

3. Respondents petitioned for review in the Tax Court, which ruled in their favor in a reviewed decision (Pet. App. 15a-39a). The court viewed the question

[4] The closing price of NL stock on the New York Stock Exchange on April 18, 1979, was $23⅛ per share; on that basis the 300,000 shares received by respondent had a value of $6,937,500. Respondent's cost basis in his 58 shares of Basin stock was $84,515, and he incurred expenses of $25,013 in connection with the merger. J.A. 28. Thus, he realized $10,077,972 in gain on the merger. Pursuant to Section 356(a)(1), respondent was required to recognize this gain only up to the amount of the cash received in the transaction, $3,250,000. Respondents erroneously listed the amount of the gain on their return as $3,195,294, but, in their later computation for entry of decision by the Tax Court, respondents acknowledged that the amount of gain recognized and reported should have been $3,250,000 (see Br. in Opp. 4 n.5). The deficiency found by the Tax Court (see J.A. 66) reflects that acknowledged error.

whether respondents' receipt of cash in the merger had the effect of the distribution of a dividend as turning on a choice between two "judicially articulated tests" set forth in *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), and *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (Pet. App. 18a). According to the Tax Court, the *Shimberg* test would treat the cash distribution as if it constituted a redemption of stock in the acquired corporation prior to the merger, and the *Wright* test would treat the cash payment as if it constituted "a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration" (Pet. App. 18a (emphasis in original)).

The Tax Court then concluded that it should follow *Wright* and treat the cash payment as part of a hypothetical post-merger redemption of the 125,000 shares of NL stock that respondent declined to accept as part of the exchange for his Basin stock. The court stated that this approach was necessary if the cash payment is to "be viewed and tested within the context of the entire reorganization" (Pet. App. 33a). Because such a redemption would have reduced respondent's hypothetical holdings in NL from 425,000 to 300,000 shares, the cash received on the hypothetical redemption would not have been essentially equivalent to a dividend under the redemption provisions of the Code (see I.R.C. § 302(b)(2)).[5] Under the Tax

[5] Under the "safe harbor" provisions of Section 302(b)(2), cash received upon a "substantially disproportionate redemption" will not be treated as a dividend. The statute defines such a redemption as one in which both the shareholder's percentage interest in voting stock in the corporation following the redemption is less than 80% of what it was before the redemption and he retains less than 50% of the voting power in the corporation following the redemption.

Court's approach, this conclusion that the funds that would have been received in a hypothetical post-merger redemption would not be treated as a dividend meant that the cash received by respondents in the reorganization should not be viewed as having the effect of a dividend either, and therefore respondents were entitled to capital gain treatment upon the reported gain. Pet. App. 34a-35a.

4. The court of appeals affirmed (Pet. App. 1a-14a). Like the Tax Court, the court of appeals approached the case as requiring it to choose between *Wright* and *Shimberg* (see Pet. App. 8a). The court first concluded that the dividend determination is to be made by importing into the reorganization context the principles applicable to the redemption of stock of a single corporation under Section 302 of the Code (Pet. App. 3a-6a). The court then concluded that the tests of Section 302 should be applied as if there had been a hypothetical redemption after a different reorganization was completed, *i.e.*, as if respondent had received 425,000 shares of NL stock in a stock-for-stock merger and thereafter had received $3,250,000 in a redemption of 125,000 of his NL shares. Under this view, the question whether the cash payment should be treated as a dividend turns on the extent of the reduction in respondent's interest in NL that would be occasioned by the hypothetical redemption of 125,000 shares of NL stock. Pet. App. 7a-11a. The court criticized the *Shimberg* approach, which it characterized as treating the cash payment as being made by the acquired corporation (Pet. App. 10a-14a). The court of appeals stated, inter alia, that this approach failed adequately to consider the "corporate control [respondent] retained after the reorganization was completed" (*id.* at 10a-11a).

SUMMARY OF ARGUMENT

1. The reorganization provisions of the Code establish an exception to the general principle that the entire amount of gain or loss must be recognized upon the sale or exchange of property. The premise of this exception is that transactions that qualify as reorganizations under the Code entail only a readjustment of continuing interests; the reorganized corporation is a continuation of the same enterprise in modified corporate form. One consequence of this premise of continuing interests is that a distribution of cash or other property in the course of the reorganization may operate as a substitute for a distribution of the accumulated earnings and profits of one of the corporations involved in the transaction—a distribution that ordinarily would be accomplished by the declaration of a dividend. Accordingly, Section 356(a)(2) provides that such a "boot" distribution in the course of a reorganization should be treated as a dividend to the extent of accumulated earnings and profits if it has "the effect of the distribution of a dividend."

The basic attribute of a dividend, derived from Sections 301 and 316 of the Code, is a pro rata distribution to shareholders out of corporate earnings and profits. When a distribution is made that is not a formal dividend, "the fundamental test of dividend equivalency" is whether the distribution is proportionate to the shareholders' stock interests (*United States* v. *Davis*, 397 U.S. 301, 306 (1970)). Accordingly, this Court concluded in the context of a pro rata redemption that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316" (*id.* at 312), and the same is true of pro rata distributions of boot in the course of a reorganization. A payment of boot made on a pro rata basis to the shareholders of one of the corporations in-

volved in a reorganization (including, as in this case, a corporation wholly owned by one shareholder) thus has all the earmarks of a dividend. Moreover, it clearly has the "effect" of a dividend in that the shareholders are in precisely the same position after a reorganization that includes boot in the amount of retained earnings and profits that they would have been in had the corporation instead declared out those earnings and profits as a dividend before entering into a reorganization without boot. Therefore, a long line of authority has held that a pro rata distribution of boot in the course of a reorganization to the shareholders of the acquired corporation has "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2).

2. The court of appeals erred in holding that whether a boot distribution has "the effect of the distribution of a dividend" must be determined by first recasting the transaction actually entered into by the parties--substituting a pure stock-for-stock reorganization followed by a redemption of some of the shares for cash in the amount of the boot actually received--and then applying to that hypothetical transaction the principles of Section 302 of the Code that govern redemptions. There is no reason generally to import with full effect the principles of Section 302 into the Section 356(a)(2) inquiry; the two provisions address different types of transactions and the reasons that impelled Congress to except certain redemptions from dividend treatment do not necessarily apply in the reorganization context. Cases like this one involving pro rata boot distributions can and should be resolved simply by reference to the terms of Section 356(a)(2) because such distributions have all the earmarks of a dividend.

The court of appeals' hypothetical redemption analysis violates the general principle that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once

having done so, he must accept the tax consequences of his choice." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). The stock-for-stock reorganization hypothesized by the court of appeals is precisely the option that respondent rejected in favor of a transaction involving boot; he decided to reject that option for good reasons of his own (see note 2, *supra*), and there is no reason to permit him to enjoy its tax consequences. The hypothetical redemption scenario also introduces other difficulties into the Section 356(a)(2) analysis. Because the distribution is to be measured against the earnings and profits of the acquired corporation to determine how much of it can be a dividend, the court of appeals' approach imputes to Congress the intent to establish a peculiar mode of analysis under Section 356(a)(2)--the boot is to be viewed as coming from the *acquiring* corporation for purposes of determining whether it has "the effect of the distribution of a dividend," but it is to be viewed as coming from the *acquired* corporation for purposes of comparing it to earnings and profits. Moreover, the court of appeals' approach requires a court to base its decision upon what may be an extremely speculative judgment as to the number of shares that would be redeemed in the hypothetical transaction.

Finally, the hypothetical redemption scenario does not comport with the terms of the statute. Under Section 356(a)(2), a boot payment must be treated as a dividend as long as it has "the effect of the distribution of a dividend." It is clear that the pro rata distribution in this case had the effect of a dividend distribution by Basin. At most, the court of appeals' analysis seeks to demonstrate that the boot payment also had the effect of a different transaction--a hypothetical redemption. But, even if that were true, it would not alter the result under the terms of Section 356(a)(2). In any event, it is not correct to say that the

boot distribution here had the same effect as the hypothetical post-merger redemption analyzed by the court of appeals. If the parties in fact had engaged in the hypothesized transaction, the recognized gain would have been different, as would as the continuing earnings and profits accounts of the surviving corporations and respondent's basis in his NL shares. There is no basis for equating the two transactions for purposes of Section 356(a)(2) analysis.

ARGUMENT

RESPONDENT'S RECEIPT OF CASH, IN ADDITION TO NL STOCK, IN EXCHANGE FOR HIS BASIN STOCK HAD THE EFFECT OF THE DISTRIBUTION OF A DIVIDEND WITHIN THE MEANING OF SECTION 356(A)(2) OF THE CODE

Respondent surrendered all of his shares of Basin stock in a transaction qualifying as a reorganization under Section 368 of the Code. In return, he received both shares of NL stock and cash. The question in this case is whether the cash or "boot" paid to respondent had "the effect of the distribution of a dividend" under Section 356(a)(2) of the Code. A long line of court of appeals decisions has held that a boot distribution made under circumstances parallel to those in this case—*i.e.*, on a pro rata basis to the shareholders of the acquired corporation, in this case to a sole shareholder—is to be treated as a dividend. That conclusion follows directly from the statutory language because the boot distribution closely approximates a dividend, and it has precisely the same effect. To the extent of Basin's undistributed earnings and profits (of which there were more than $2 million at the time of the merger), the payment had all the earmarks of a classic dividend; it was a distribution of cash out of a corporation's earnings and

profits made on a pro rata basis to its shareholders. And respondent was in precisely the same position after the merger that he would have been in had the amount of Basin's accumulated earnings and profits been distributed to him as a formal dividend, rather than as part of the boot received in the reorganization. To the extent of those earnings and profits, therefore, the boot distribution had "the effect of the distribution of a dividend."

The court of appeals, however, rejected this conclusion and the line of authority that supports it. The court did so by recasting the merger transaction into a form different from that entered into by the parties—indeed, into a form that respondent had explicitly rejected in the merger negotiations. The court of appeals ruled that the transaction should be treated as if respondent had received 425,000 shares of NL stock in a tax-free stock-for-stock reorganization and then subsequently had redeemed 125,000 of those shares for $3,250,000 in cash. The court then applied the dividend equivalency rules for redemptions of stock in a single corporation (I.R.C. § 302) to the hypothetical redemption that it had posited. Because application of those rules would not have resulted in dividend treatment for the hypothetical redemption, the court ruled that the boot distribution that actually occurred also should not be treated as a dividend. There is, however, no basis for believing that this hypothetical redemption analysis furthers congressional intent. It should be rejected in favor of a basic application of the terms of Section 356(a)(2), which advances the evident congressional purpose of applying dividend treatment to distributions of retained earnings and profits made in the course of a reorganization when those distributions have the effect of a dividend.

A. *The Statutory Framework*

1. The reorganization provisions of the Code constitute an explicit exception to the general principle that the entire amount of gain or loss is to be recognized upon the sale or exchange of property (see I.R.C. § 1001(c)). As this Court recently explained, the purpose of this exception is "to free from the imposition of an income tax purely 'paper profits or losses' wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form" (*Paulsen* v. *Commission*, 469 U.S. 131, 136 (1985) (internal quotation marks omitted)). The reorganization provisions seek to define the transactions in which the continuity of interest is such that it is appropriate to defer recognition of gain or loss.

Although Congress has engaged in substantial modification and refinement over the years, the basic structure of the reorganization provisions dates back to Section 202(c)(2) of the Revenue Act of 1921, ch. 136, 42 Stat. 230, and to the further development of those provisions in Section 203 of the Revenue Act of 1924, ch. 234, 43 Stat. 256-258. The Code has long defined as reorganizations six basic types of corporate transactions (see § 368(a)(1)), including a "merger or consolidation" (§ 368(a)(1)(A)).[6] Section 354(a)(1) of the Code provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities * * * in another corporation a party to the reorganization."[7] Sections 358 and 362(b) reflect the continuity

[6] A seventh type, set forth in Section 368(a)(1)(G), was added in 1980, after the tax year at issue in this case, by Section 4(a) of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3401.

[7] The transaction in this case was a "triangular merger," in which the acquired company (Basin) was merged into a subsidiary (NLAC)

of interest in the reorganized corporation by providing that the basis of the stock or securities received shall be the same as the basis of the stock or securities exchanged, and that the property received by the acquiring corporation shall have the same basis that it had in the hands of the transferor corporation.

Section 354 provides for nonrecognition of gain or loss only when the transaction involves an exchange of stock or securities *solely* for stock or securities. Some forms of reorganization, however, including the "A" (merger or consolidation) and "C" (asset acquisition (see Section 368(a)(1)(C)), permit the receipt of some additional property without losing their status as reorganizations under the Code. These types of transactions are accommodated by Section 356(a)(1), which dates back to Section 202(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 230-231 (as amended by the Act of Mar. 4, 1923, ch. 294, 42 Stat. 1560). That provision qualifies the nonrecognition rule by providing that if, in addition to the property permitted to be received by Section 354, money or other property (commonly known as "boot") is received, "then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." Sections 358 and 362 provide for appropriate adjustments to basis in order to take into account any such recognition of gain.

When it sought to improve the early reorganization provisions in 1924, Congress recognized that some adjustment to this treatment of boot was necessary. The fundamental

of a controlling corporation (NL). Pursuant to Section 368(a)(2)(D), this type of transaction qualifies as an "A" reorganization—*i.e.*, a reorganization under Section 368(a)(1)(A). Pursuant to Section 368(b), the controlling corporation (NL), whose stock was exchanged for respondent's shares of Basin, is identified as a "party to the reorganization."

premise of special reorganization treatment is the assumption of a continuing enterprise, but the predecessor of Section 356(a)(1) allowed a shareholder to receive a distribution from that enterprise without being subject to dividend treatment, even though the distribution could represent retained earnings and profits that ordinarily are taxed as a dividend when distributed to a shareholder. Accordingly, Congress enacted what is now Section 356(a)(2), providing that, when the exchange "has the effect of the distribution of a dividend," boot received in a reorganization is to be treated as a dividend to the extent of the distributee's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." [8]

[8] The congressional reports on the 1924 amendment that is now codified as Section 356(a)(2) stated that the change was necessary to prevent "evasions" and gave the following example to demonstrate the need for the change (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924); see also S. Rep. 398, 68th Cong., 1st Sess. 16 (1924)):

> Corporation A has capital stock of $100,000 and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> On the other hand, corporation A may organize corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of corporation A in exchange for their stock in corporation A. Under the existing law, the $50,000 distributed with the stock of corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain.

The "surtax" at that time was the graduated portion of the income tax, which applied to dividends but not to capital gains. See generally *United States* v. *Wells Fargo Bank*, No. 86-1521 (Mar. 23, 1988), slip op. 5.

2. Section 356(a)(2) does not define the phrase "has the effect of the distribution of a dividend," but the Code elsewhere specifically addresses the tax treatment of "dividends." Section 301(a) of the Code provides: "Except as otherwise provided in this chapter, a distribution of property * * * made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." That subsection provides that, for distributions described in subsection (a), "[t]hat portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income." Section 316, in turn, broadly defines a dividend as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits," either those earnings and profits accumulated after February 28, 1913, or those of the taxable year. The statute goes on to provide that "[e]xcept as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." Thus, the rule that emerges from the combination of these provisions is that a distribution of property made by a corporation to its shareholders with respect to its stock is to be included in gross income as a dividend to the extent of the corporation's earnings and profits.

It is established beyond doubt that these statutory provisions require dividend treatment for corporate distributions that are made to shareholders on a pro rata basis, since such distributions are clearly "with respect to [the corporation's] stock," as specified in Section 301. In *United States* v. *Davis*, 397 U.S. 301, 306 (1970), this Court held that a pro rata redemption of stock by the corporation is "essentially equivalent to a dividend" (I.R.C. § 302(b)(1)), regardless of its purpose. The Court described as "the fundamental test of dividend equivalency" whether a distribution to a shareholder is "pro rata or pro-

portionate to his stock interest," and the Court concluded that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302 [the provision dealing with stock redemptions]" (397 U.S. at 312). In the same vein, the courts of appeals have consistently recognized that the basic earmark of a dividend is a "pro rata distribution out of corporate earnings and profits" (*Hawkinson* v. *Commissioner*, 235 F.2d 747, 751 (2d Cir. 1956)).[9] These principles derived from Sections 301 and 316 provide the basic framework for determining whether a boot distribution "has the effect of the distribution of a dividend" under Section 356(a)(2).

B. The Payment Of Boot In A Reorganization On A Pro Rata Basis To The Shareholders Of The Acquired Corporation Has The Effect Of The Distribution Of A Dividend

The resolution of this case turns entirely on the correct application of Section 356(a)(2) of the Code. It is undisputed that the merger transaction qualified as a reorganization under Section 368 of the Code and therefore that, under Section 356(a)(1), the gain on the exchange must be recognized in the amount of the $3,250,000 in boot received by respondent in the ex-

[9] See also, *e.g.*, *Metzger Trust* v. *Commissioner*, 693 F.2d 459, 462 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983); *Agway, Inc.* v. *United States*, 524 F.2d 1194, 1198 (Ct. Cl. 1975) (quoting *Himmel* v. *Commissioner*, 338 F.2d 815, 817 (2d Cir. 1964) (emphasis in original)) (" 'The hallmarks of a dividend, then, are pro rata distributions of earnings and profits *and* no change in basic shareholder relationships.' "); *Ballenger* v. *United States*, 301 F.2d 192, 196-197 (4th Cir. 1962); *Bradbury* v. *Commissioner*, 298 F.2d 111, 116 (1st Cir. 1962) (quoting Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 Tax L. Rev. 437, 476 (1950)) (" 'the most obvious earmark[ ] of a dividend is the pro rata distribution of earnings and profit[s]' [which is] the basic criterion of whether a particular distribution more closely equates a sale or a dividend.").

change. The tax treatment of that amount of gain, however, depends upon whether the exchange "has the effect of the distribution of a dividend" within the meaning of Section 356(a)(2). If it does, then the boot should be treated as a dividend to the extent of Basin's undistributed earnings and profits ($2,319,611) and therefore taxed as ordinary income; if the exchange does not have the effect of a dividend, then the boot should be taxed as capital gain. We submit that the type of distribution that occurred in this case—on a pro rata basis to the shareholders of the acquired corporation—has the "effect of the distribution of a dividend" under Section 356(a)(2).

1. As we have noted, the basic attribute of a dividend is a pro rata distribution to shareholders out of corporate earnings and profits. That is what occurred here. Basin had $2,319,611 in undistributed earnings and profits at the time of the merger. In the course of the merger, that amount (and more) of cash was distributed to respondent, Basin's sole shareholder. Since any distribution to a sole shareholder is, by definition, a pro rata distribution (see *United States* v. *Davis*, 397 U.S. at 307), the payment to respondent in this case was "with respect to [his] stock" (I.R.C. § 301) and had all the earmarks of a dividend.

It is true, of course, that the payment to respondent in this case came from NL and therefore did not formally come out of Basin's earnings and profits. But Section 356(a)(2) does not require that the boot distribution literally constitute a formal dividend under Section 316. As we have seen, Congress recognized that a formal dividend test was inappropriate because boot distributions might not clearly be made by a single corporation, but rather could occur in the course of a reorganization involving more than one corporation. For that very reason, Section 356(a)(2) requires only that the exchange have "the *effect* of the distribution of a dividend" (emphasis added). This

condition is clearly satisfied when a pro rata distribution of boot is made in the course of a transaction that falls within the reorganization provisions of the Code.

The principle underlying the statutory reorganization treatment conferred upon respondent's merger transaction is that the reorganization yields "a continuance of the proprietary interests in the continuing enterprise under modified corporate form" (*Lewis* v. *Commissioner,* 176 F.2d 646, 648 (1st Cir. 1949)). See also *Paulsen* v. *Commissioner,* 469 U.S. at 136; Treas. Reg. § 1.368-1(b) (reorganizations effect "only a readjustment of continuing interest[s] in property under modified corporate forms"). This principle lies "at the heart of the nonrecognition provisions and is the reason why gain or loss, although realized, is not recognized at the time of the exchange." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.01, at 14-4 (4th ed. 1979).

Because respondent's interest in the reorganized corporate entity is thus regarded as a continuation of his interest in Basin, it follows that it should make no difference that the payment to him formally came from NL, rather than Basin. It still should be deemed to have been "made out of earnings and profits to the extent thereof" (I.R.C. § 316(a)).[10] In sum, as the Fifth Circuit stated in connec-

[10] The nonrecognition rules of the reorganization provisions, of course, operate as a limited exception to the broadly applicable dividend provisions of Section 316. The relevant regulations explicitly provide that "[t]he general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof * * * does not apply to * * * [t]he distribution, in pursuance of a plan of reorganization, * * * [o]f *stock or securities*" of corporate parties to the reorganization (Treas. Reg. § 1.312-11(b) (emphasis added)). Clearly, however, the rule of Section 316 continues to apply to money or other property distributed pursuant to the plan of reorganization. See Treas. Reg. § 1.356-1.

tion with a boot distribution indistinguishable from the one in this case, "[i]f a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,' it follows that the pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of § 356(a)(2)" (*Shimberg* v. *United States,* 577 F.2d 283, 288 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (quoting *Lewis* v. *Commissioner,* 176 F.2d at 648)). See also Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2),* 39 Tax L. Rev. 297, 324 (1984) (describing the logic of the above quotation as "unassailable").[11]

Moreover, there can be no doubt that the boot distribution here had the same "effect" that a direct dividend distribution by Basin of its earnings and profits would have had. The distribution of such a dividend would have reduced the value of Basin by the amount of the dividend and accordingly reduced the amount of the boot that NL

[11] If it were not for the nonrecognition treatment accorded by Congress for reorganizations, of course, both the amount of the boot and the rest of the more than $10 million of gain realized upon the Basin-NL transaction would have been recognized and treated as capital gain from the *sale* of a capital asset. But the parties to the merger here sought to have the transaction treated not as a sale, but as a tax-free reorganization, and therefore it is not appropriate to regard the boot as the proceeds of the sale of a capital asset, which would confer a "double benefit of nonrecognition and capital gain" (Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations,* 31 Case W. Res. 1, 27 (1980)). See generally Kyser, *supra,* 39 Tax L. Rev. at 325-326. The premise of the nonrecognition treatment is the continuing interest of the participating shareholders in the reorganized entity, as opposed to a sale; Section 356(a)(2) recognizes that another consequence of that continuing interest is that boot distributions in the course of the reorganization can have the effect of dividends and should be taxed accordingly.

would have given in exchange for respondent's stock. The post-merger financial situation of both respondent and the reorganized corporation would have been the same, whether the amount of Basin's earnings and profits were distributed to respondent as boot or as a dividend; hence, in the words of the congressional reports accompanying the original version of Section 356(a)(2), the "effect" was "the same as if the corporation had declared out as a dividend its * * * earnings and profits" (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924); S. Rep. 398, 68th Cong., 1st Sess. 16 (1924); see note 8, *supra*). See *Shimberg* v. *United States,* 577 F.2d at 288.

More generally, dividend treatment of boot distributions made pro rata to the shareholders of the acquired corporation is logical and comports with the apparent congressional purpose to restrict the use of reorganizations as an avenue to withdraw profits from a corporation without declaring a dividend. As one commentator has noted, "intuition suggests that what is really going on [with such a boot payment] is that the shareholders of the target are making use of their last opportunity to withdraw profits from their corporation before they lose control as a result of dilution by the reorganization" (Kyser, *supra,* 39 Tax L. Rev. at 326). There is nothing unfair or unreasonable about treating such a boot payment as a dividend. The shareholders of the target—respondent alone in this case—are the ones who earned the profits and allowed them to accumulate in the target corporation rather than distributing them as dividends prior to the reorganization. They are also the persons who negotiate the terms of the acquisition with the acquiring corporation, including the extent to which there will be a payment of boot and whether the acquisition will be structured as a tax-free reorganization, rather than a taxable sale. The boot, then, appears to be simply a substitute for the undeclared dividends; the shareholders "realize[ ] some or all of the value from earnings of the transferor corporation at the time of the reorganization rather than realizing it at a prior time" (Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations,* 31 Case W. Res. 1, 35 (1980)). See generally Kyser, *supra,* 39 Tax L. Rev. at 341-342. Thus, it requires a tortured reading of Section 356(a)(2) to conclude that such a pro rata boot distribution does not have "the effect of the distribution of a dividend."

2. The judicial interpretations of Section 356(a)(2) since its enactment in 1924 strongly support the conclusion that it contemplates dividend treatment for boot that is distributed pro rata to the shareholders of the acquired corporation. A long and consistent line of court of appeals decisions in the wake of the 1924 Act recognized that, where two corporations not previously under common control are unified, either by statutory merger or consolidation (I.R.C. § 368(a)(1)(A)) or by the transfer of substantially all of the assets of one to the other in exchange for voting stock of the latter (I.R.C. § 368(a)(1)(C)), and the shareholders of one or both corporations receive a pro rata payment of boot, that payment has the effect of a dividend and is to be taxed as such. The first case in this line is *Commissioner* v. *Owens,* 69 F.2d 597 (5th Cir. 1934), where two banks merged and the shareholders of the smaller bank received pro rata both stock in the new bank and cash. The court held that "so much of [the cash] as might before consolidating have been declared by their corporation as an ordinary dividend out of its profits is by [the predecessor of Section 356(a)(2)] to be so taxed" (69 F.2d at 598). The court specifically noted (*ibid.*): "It is true that the money was not distributed by the [acquired bank] and thus was not literally a dividend of that bank. But the statute speaks of a distribution which 'has the effect of the distribution of a

dividend.' This pro rata payment to all stockholders of the [acquired bank] * * * certainly has that effect."

Subsequently, several other courts of appeals reached the same conclusion regarding boot received on a pro rata basis. See *King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 521 (Ct. Cl. 1969) ("The distribution on a pro rata basis, entailing no substantially disproportionate change in the continuing equity interests of the Tenco stockholders, constituted a classic example of a transaction having the effect of the distribution of a dividend."); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribution had all the earmarks of a taxable dividend, i.e., a pro rata distribution out of corporate earnings and profits"); *Campbell* v. *United States,* 144 F.2d 177, 182 (3d Cir. 1944) ("We [previously] held that when cash was distributed in a reorganization to the stockholders of the predecessor company that part of the amount thus distributed which equalled the accumulated earnings of the predecessor corporation had the effect of a taxable dividend and was accordingly taxable as such."); see also *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *Rose* v. *Little Investment Co.,* 86 F.2d 50 (5th Cir. 1936); *Commissioner* v. *Forhan Realty Co.,* 75 F.2d 268 (2d Cir. 1935); *Sheldon* v. *Commissioner,* 6 T.C. 510 (1946); *Woodard* v. *Commissioner,* 30 B.T.A. 1216, 1229-1230 (1934); *Woodward* v. *Commissioner,* 23 B.T.A. 1259 (1931); but see *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973) (rejecting dividend treatment for distribution to 99% shareholder where there was commonality of ownership in the merging corporations).[12] On the other hand, where the cash payment

[12] All of these cases (except *Wright*), like the present one, involve "A" or "C" reorganizations of corporations not under common control. There are many more cases requiring dividend treatment for boot

was not pro rata to the shareholders of one of the corporations, but rather was made only to holders of preferred stock who did not own any common stock in order to call and retire that preferred stock, the payment was held not to have the effect of a dividend. *Idaho Power Co.* v. *United States,* 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958).

This line of cases also repeatedly reaffirmed the conclusion of the court in *Owens* (see 69 F.2d at 598) that it is immaterial which corporation actually pays out the cash to the shareholders. While that may be relevant to whether the payment is *technically* a dividend, it has no bearing on whether the payment has "the effect of the distribution of a dividend." As the Court of Claims stated, "regardless of who physically paid out the money, and regardless of whose name is placed on those earnings, the effect is the same as if the Trust Company [the acquired corporation] had made a distribution out of funds specifically labeled 'Trust Company earnings and profits' " (*Ross* v. *United States,* 173 F. Supp. at 798). See also *Campbell* v. *United States,* 144 F.2d at 182; *Woodward* v. *Commissioner,* 23 B.T.A. at 1262.

This established line of authority was noted approvingly and relied upon by this Court in *Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945). That case dealt with a factual situation somewhat different from the one here in that it involved a recapitalization (an "E" reorganization),

received in a "D" reorganization ("a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders * * * is in control of the corporation to which the assets are transferred," I.R.C. § 368(a)(1) (D)). See, *e.g., DeGroff* v. *Commissioner,* 444 F.2d 1385 (10th Cir. 1971); *Liddon* v. *Commissioner,* 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); *Lewis* v. *Commissioner, supra; Love* v. *Commissioner,* 113 F.2d 236 (3d Cir. 1940).

which is the one form of reorganization that involves a single corporation. The taxpayer estate in *Bedford* was a shareholder of a corporation that had accumulated earnings and profits, but was disabled under state law from declaring dividends. To remedy that situation, the corporation amended its capital structure. In exchange for its 3,000 shares of preferred stock, the estate received 3,500 shares of a lesser preferred, 1,500 shares of common stock, and $45,240 in cash. Invoking the statutory definition of "dividend" in the predecessor of Section 316, the Court concluded that the cash must be regarded as having come out of the corporation's accumulated earnings and hence had the effect of a distribution of a dividend (325 U.S. at 290). The Court buttressed its holding by referring with approval to the existing cases cited above (see pages 21-22, *supra*) that required dividend treatment in the case of reorganizations involving two corporations. The Court stated (325 U.S. at 291): "It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of the distribution of a taxable dividend under [the predecessor of Section 356(a)(2)]. * * * We cannot distinguish the two situations and find no implication in the statute restricting [the predecessor of Section 356(a)(2)] to taxation as a dividend only in the case of an exchange of stock and assets of two corporations." [13]

[13] In the course of rejecting an alternative argument made by the estate, the Court made the statement that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' " (325 U.S. at 292). This statement was read by some as establishing an "automatic dividend rule" that would accord dividend treatment to any cash received on a reorganization, whether pro rata or not – for example, cash distributed to dissenters from a merger who demand appraisal of their stock (see, *e.g.*, *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970)). This "automatic dividend rule" was heavily criticized by the commentators (see, *e.g.*, Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965); Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266, 268-275 (1946)). The post-*Bedford* cases in this area have rejected this broad reading of this Court's decision and have concluded that this Court was not attempting to establish a rule that would extend to cases involving a non-pro-rata distribution, which was not involved in *Bedford*. See *Shimberg* v. *United States*, 577 F.2d at 290 & n.19; *King Enterprises, Inc.* v. *United States*, 418 F.2d at 520; *Hawkinson* v. *Commissioner*, 235 F.2d at 750-751; *Ross* v. *United States*, 173 F. Supp. at 797. The IRS has also rejected this broad reading of *Bedford*. See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

This line of court of appeals authority was capped by

The court of appeals here, however, completely misunderstood the nature of the debate over the "automatic dividend rule". The court erroneously described the abandoned reading of *Bedford* as stating "that any pro rata distribution in a reorganization must automatically be treated as a dividend" (Pet. App. 6a) and, in the same vein, it erroneously stated (*id.* at 11a) that the government's contention here "comes close to resurrecting the abandoned automatic dividend rule of *Bedford*." The "abandoned automatic dividend rule" is one that would have required dividend treatment for any distribution, even one that was not pro rata. And the critics of the broad reading of *Bedford* did not question the propriety of dividend treatment for pro rata distributions. See, *e.g.*, Shoulson, *supra*, 20 Tax L. Rev. at 608; Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Colum. L. Rev. 1, 48 (1952) ("the possible implication of the *Bedford* decision, that any boot on a reorganization is a dividend, would not be followed, so that boot distributions which are *disproportionate* to common stock holdings would not be regarded as dividends." (footnote omitted; emphasis added)). The longstanding rule for pro rata distributions has not been abandoned; as we have shown, it has been consistently applied by the courts of appeals since 1934 and was approved by this Court in a portion of the *Bedford* opinion that has never been questioned. Because the present case involves a pro rata distribution, the "abandoned automatic dividend rule" (Pet. App. 11a) is not implicated.

Shimberg v. *United States, supra.* As the Tax Court noted below (Pet. App. 27a), the facts of *Shimberg* are essentially indistinguishable from those here. A smaller corporation was there merged into a larger one, and the shareholders of the acquired corporation received shares in the acquiring corporation, plus $625,000 in cash, to be allocated among the shareholders on a pro rata basis. The court of appeals upheld the Commissioner's determination that the boot was taxable as a dividend. The court noted the long line of authority supporting the proposition that pro rata boot distributions have the effect of a dividend (577 F.2d at 288), and it found distinguishable the one decision that diverged from this line, *Wright* v. *United States, supra,* because of the commonality of ownership of the combining corporations there (577 F.2d at 287 (see note 16, *infra*). The court explained the basis for its conclusion as follows (*id.* at 288):

> If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2). * * * Moreover, the legislative history of § 356(a)(2)'s predecessor statute makes clear that a distribution that would have been a dividend if made prior to the reorganization is subject to the same treatment when made as part of the transaction.

The court concluded that "[t]he taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger

in the form of a dividend" (577 F.2d at 289). See also *General Housewares Corp.* v. *United States,* 615 F.2d 1056, 1066 (5th Cir. 1980). Thus, a consistent line of decisional law confirms that boot distributed on a pro rata basis to the shareholders of the acquired corporation has the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2).

C. The Substitution Of A Hypothetical Scenario, Consisting Of A Reorganization Without Boot Followed By A Partial Stock Redemption, In Place Of The Actual Reorganization Involving Boot Is Not The Correct Method Of Determining Whether The Actual Boot Distribution Has The Effect Of A Dividend Under Section 356(a)(2)

The court of appeals in this case did not directly examine the merger transaction entered into by the parties to determine whether the exchange involving boot had the effect of the distribution of a dividend. Instead, the court first addressed the abstract question whether the determination of dividend treatment under Section 356(a)(2) must be made by applying the principles set forth in Section 302 of the Code. That Section governs the tax treatment of redemptions of stock in a single corporation. It provides, inter alia, that a redemption will be treated as an exchange if it "is not substantially equivalent to a dividend" (§ 302(b)(1)); and it establishes "safe harbors" under which a redemption that causes a specified reduction in the shareholder's percentage interest in the corporation is automatically insulated from being found to be substantially equivalent to a dividend (§ 302(b)(2); see note 5, *supra*). Largely because of the similarity in the language of the two sections with respect to dividend treatment, the court of appeals concluded that Section 302 must be applied to determine when a boot distribution has "the effect of the distribution of a dividend" under Section 356(a)(2) (see Pet. App. 5a).

Having concluded that Section 302 principles must be applied, the court of appeals then needed to find a redemption to which to apply them, since the merger transaction entered into by the parties did not involve a redemption. Following the path indicated by *Wright* v. *United States, supra,* the court recast the merger transaction to create a hypothetical redemption. The court constructed a scenario based upon a pure stock-for-stock reorganization in which respondent received 425,000 shares of NL stock – which was precisely the option offered to and rejected by respondent in the merger negotiations – followed by a post-merger redemption of 125,000 of those shares in exchange for the $3,250,000 that had been distributed to respondent as boot in the actual transaction (Pet. App. 7a-11a). Because that hypothetical redemption, standing alone, would have satisfied the "safe harbor" of Section 302(b)(2) by reducing respondent's interest in NL from 1.3% to 0.92%, it would not have been taxed as a dividend (see Pet. App. 7a, 34a). In the court of appeals' view, this conclusion concerning the hypothetical redemption necessarily meant that the boot distribution did not have "the effect of the distribution of a dividend" under Section 356(a)(2). The court of appeals' analysis is flawed in several respects.

1. Most fundamentally, the court erred in beginning its analysis by focusing on the abstract question whether Section 302 principles govern, and the rest of its analysis compounds this error. Obviously, the starting point of the analysis must be the terms of Section 356(a)(2), the section that Congress made applicable to boot distributions. If that section appears inadequate to its task in a particular case, it may be appropriate to look elsewhere in the Code for guidance, such as to Section 302 (see note 15, *infra*). But in the situation presented here, a pro rata distribution of boot to the shareholders of the acquired corporation,

Section 356(a)(2) itself clearly indicates that the boot should be treated as a dividend to the extent of accumulated earnings and profits. See point B, *supra.* There was thus no reason for the court of appeals to look to Section 302.

Second, the court of appeals further erred in concluding that Section 302 should be imported with full effect into the reorganization context to determine when boot should be treated as a dividend under Section 356(a)(2). It is true, of course, that there is some relationship between the two sections; both provisions address the question whether a particular transaction should be treated as a dividend, and they use similar language. Nevertheless, there are also significant differences. Most notably, Section 302 is addressed to a transaction between a shareholder and a single corporation, while Section 356 deals with a reorganization transaction frequently involving two, often unrelated, corporations. Section 302's allowance of exchange treatment for certain redemptions is an exception to the general rule that corporate distributions are taxable as dividends (see *United States* v. *Davis,* 397 U.S. at 304). There is no reason to assume that the reasons that impelled Congress to create that exception should apply equally in the reorganization context so that every nuance and detail of Section 302 should be applied in interpreting Section 356(a)(2). See generally Samansky, *supra,* 31 Case W. Res. at 17-20, 29.[14] Thus, there is no logical reason why the

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[14] Indeed, to the extent the redemption provisions were designed to provide an opportunity for shareholders of closely held corporations to sell their stock back to the corporation for capital gain where there is no outside market for the stock (see, *e.g.*, Pedrick, *Some Latter Day Developments in the Taxation of Liquidating Distributions,* 50 Mich. L. Rev. 529, 530 (1952)), the purpose of the redemption provisions has little relevance to the reorganization context. In the latter context, the shareholder does not need a special opportunity provided by Congress to sell his shares of stock; the reorganization demonstrates that there

characterization of boot distributions should necessarily be governed by Section 302 principles.

At all events, under a proper analysis the theoretical question whether Section 302 redemption principles should be applied to determine the effect of boot distributions under Section 356(a)(2) is of no practical significance in a case like this one, where the distribution is made on a pro rata basis to the shareholders of one of the corporations. A pro rata redemption of stock is "essentially equivalent to a dividend" and therefore taxable as a dividend under Section 302(d). That is clear from *United States* v. *Davis, supra,* where this Court upheld dividend treatment for a pro rata redemption, noting that whether or not the distribution is pro rata is "the fundamental test of dividend equivalency" (397 U.S. at 306). The Court's conclusion in *Davis* that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302" (*id.* at 312) applies to all pro rata distributions of cash—whether as a formal dividend, in exchange for the redemption of stock, or in the course of a reorganization. Thus, whether Section 356(a)(2) is applied directly to the pro rata boot distribution in this case, or, alternatively, whether reference is made to Section 302 redemption principles, should not affect the ultimate conclusion that the pro rata distribution has "the effect of the distribution of a dividend" under Section 356(a)(2).[15]

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is a market for them. Instead, he has deliberately chosen to transfer his stock by means of a tax-free reorganization, which is the antithesis, for tax purposes, of a sale, and he should not be relieved from the consequences of that choice.

[15] This is not to say that Section 302 principles can never have any relevance to the Section 356(a)(2) analysis. On the contrary, in the context of a non-pro-rata boot distribution, which does not have all the earmarks of a dividend, reference to Section 302 may provide

The authorities relied upon by the courts below confirm that, in the context of a pro rata boot distribution, the abstract inquiry into whether Section 302 principles apply is merely a theoretical diversion that provides no basis for failing to treat the boot as a dividend. The courts below based their incorporation of Section 302 into Section 356(a)(2) analysis primarily upon the assertion that "the courts have consistently held that the sections should be read *in pari materia*" (Pet. App. 5a, 23a). The courts below (and respondents (see Br. in Opp. 8)) clearly erred in reading the cases they cite as justifying the substitution of a hypothetical redemption analysis for the longstanding rule that pro rata boot distributions have the effect of a dividend. Each of the cases relied upon, except one, is a case that held that a pro rata boot distribution *should* be treated as a dividend.[16] As the court explained in *Ross* v.

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helpful guidance in approaching the Section 356(a)(2) question. Thus, the court in *Shimberg* noted that it did not totally reject the relevance of redemption principles in the context of a reorganization (577 F.2d at 290). By the same token, the Commissioner has stated that the principles developed under Section 302 for determining dividend equivalency may "in appropriate cases" serve as "useful guidelines for purposes of applying section 356(a)(2)" (Rev. Rul. 74-516, 1974-2 C.B. at 122). See also Rev. Rul. 75-83, 1975-1 C.B. 112; H.R. Conf. Rep. 98-861, 98th Cong., 2d Sess. 845 (1984). But these principles become useful only in the context of a non-pro-rata distribution. There is no need to refer to Section 302 when the distribution is pro rata (although looking to Section 302 would produce the same result (see Rev. Rul. 75-83, *supra*)); the payment is clearly a dividend. Therefore, this case presents no occasion to consider to what extent the detailed formulations of Section 302 should be applicable in the case of a non-pro-rata boot distribution (see, *e.g.*, Pet. App. 12a) or whether, in such circumstances, a different result could obtain under Section 356(a)(2) than would be indicated by Section 302.

[16] See *Shimberg* v. *United States, supra; King Enterprises, Inc.* v. *United States,* 418 F.2d at 521 ("little doubt" that pro rata boot distribution should be treated as a dividend because it is a "classic example of a transaction having the effect of the distribution of a dividend"); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribu-

United States, 173 F. Supp. at 797, all that is meant in these cases by reading the two statutes *in pari materia* is that in both situations it is necessary to look at "all the facts and circumstances surrounding the distribution."

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tion had all the earmarks of a taxable dividend, *i.e.*, a pro rata distribution out of corporate earnings and profits"); *Ross* v. *United States, supra.*

Wright v. *United States, supra,* does lend a measure of support to the decision below since it looked to a hypothetical post-reorganization redemption to determine whether a boot distribution was a dividend. *Wright,* however, arose in a very different factual context and provides little guidance for the instant case. In *Wright,* the pre-reorganization landscape was composed of three corporations owned largely by the same two persons, but in different proportions. These two major shareholders sought to merge two of the corporations to produce a new corporation that would have the same relative ownership percentages as the third corporation. Because of the differing ownership percentages in the original corporations and the differing sizes of those corporations, however, this result could not be achieved by means of a pure stock-for-stock reorganization and therefore the transaction contained a component of boot issued by the new corporation to the majority shareholder. Stressing that "[t]he corporations involved did not exist separately but were owned and controlled by the same shareholders" (482 F.2d at 607), the court of appeals concluded that the transaction should be analyzed as if the amount of the boot had been distributed by the new corporation in a redemption of stock hypothetically received by the majority shareholder in a reorganization not involving boot. Whatever the merit of that conclusion in *Wright,* it should have little bearing here. As the Fifth Circuit noted in *Shimberg,* the "commonality of ownership" of the merging corporations appeared to have played a large part in the Eighth Circuit's decision in *Wright* to recast the transaction as a redemption of stock in a single corporation; *Wright* did not purport to deal with a situation in which previously separate and independent corporations were involved in a reorganization (see 577 F.2d at 287). Accordingly, regardless of whether *Wright* was correctly decided on its facts, cases like *Shimberg* and the instant case "present[ ] radically different facts and call[ ] for correspondingly different analysis" (577 F.2d at 287).

These cases clearly stand for the proposition that, whether or not Section 302 principles are invoked, the result of this inquiry into the "facts and circumstances" must result in dividend treatment when the boot distribution is made on a pro rata basis to the shareholders of the acquired corporation.[17]

2. In addition to the theoretical weaknesses of the court of appeals' general importation of Section 302 principles into the reorganization context, there are several more specific difficulties with the court's hypothetical post-reorganization redemption analysis. First and foremost, the court of appeals' approach runs directly contrary to the general principle that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.,* 417 U.S. 134, 149 (1974). See also *Don E. Williams Co.* v. *Commissioner,* 429 U.S. 569, 579-580 (1977). The conflict with this principle is particularly stark in this case because the court of appeals not only has failed to hold respondent to the tax consequences of the transaction that he chose, it has given him the tax consequences of an option that was offered to him by NL, and that he deliberately rejected for sound reasons of his own. Respondent presumably acted prudently and according to

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[17] The court in *Ross* noted that a particular focus of this inquiry should be into whether the declaration of a dividend "would have accomplished the same result" as the boot distribution. 173 F.Supp. at 798. That inquiry strongly confirms that dividend treatment is appropriate here. As the record plainly shows, the result of the boot distribution in this case was to allow respondent to withdraw in the form of cash some of the fruits of his labors in Basin, rather than to have all of them tied up in the future of NL in the form of stock (see J.A. 58-59). Such a withdrawal is precisely the purpose of an ordinary dividend distribution.

his best judgment in deciding to take cash and stock upon the merger of his corporation into NLAC, rather than committing substantially all of his resources to a large corporation in which he would be a minority shareholder (see note 2, *supra*). The court below erred in relieving him of the tax consequences of that choice and instead giving him the tax consequences of the very option that he declined.[18]

The hypothetical post-reorganization redemption analysis also creates practical difficulties in the application of Section 356(a)(2). A boot distribution is taxable as a dividend if it has "the effect of the distribution of a dividend," but only to the extent of the distributee's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." It is generally recognized that, at least in the case of a reorganization involving two unrelated corporations like that in this case, the corporation against whose earnings and profits the boot distribution must be measured is the acquired corporation, *i.e.*, the corporation whose shareholders are the recipients of the distribution. See, *e.g.*, *Atlas Tool Co.* v. *Commissioner,* 614 F.2d 860, 868 (3d Cir. 1980), cert. denied, 449 U.S. 836 (1980); *American Mfg. Co.* v. *Commissioner,* 55 T.C. 204, 230-231 (1970); cf. *Davant* v. *Commissioner,* 366 F.2d 874, 887-890 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967) (holding that earnings and profits of both corporations can be examined where there was commonality of ownership). That conclu-

[18] Moreover, it is an unusual feature of this case that the record shows that respondent was offered the option of a pure stock-for-stock reorganization. In the typical case, the hypothetical redemption approach takes a court down a road that may never have even been a possibility. There is generally no basis for assuming that a corporation that acquires another in a reorganization involving boot would necessarily have been willing to issue a greater number of shares in order to make a pure stock-for-stock acquisition.

sion is plainly the most sensible reading of the statute. The background of Section 356(a)(2) suggests that it was passed because "Congress was concerned with a bailout of the earnings and profits of the transferor corporation" (*American Mfg. Co.* v. *Commissioner,* 55 T.C. at 230). Moreover, it is difficult to conceive of a shareholder's having a "ratable share" of the earnings and profits of a corporation in which he held no interest prior to the reorganization.[19] Indeed, the parties stipulated in this case that the amount of the dividend was to be measured against the earnings and profits of Basin, and the courts below did not dispute the correctness of this interpretation (see Pet. App. 8a, 31a).

Thus, the approach of the court below is not consistent in identifying the source of the distribution. It contemplates that the boot distribution be viewed as having been made by the *acquiring* corporation (or, in this case, by its parent, NL) in a hypothetical stock redemption for purposes of determining whether it has the effect of a dividend under Section 356(a)(2), but then it contemplates that the distribution be viewed as having been made by the *acquired* corporation for purposes of determining whether it exceeds the shareholders' ratable share of earnings and profits. There is no reason to impute to Congress an intent to establish such a perverse approach to the basic Section 356(a)(2) determination whether a particular boot distribution should be taxed as a dividend.

[19] In addition, a rule measuring the dividend against the earnings and profits of the acquiring corporation would completely undermine the statutory purpose in some situations. For example, here, if NL had had no accumulated earnings and profits, respondent would escape dividend treatment even if it were agreed that the boot distribution had "the effect of the distribution of a dividend," despite the fact that he had accumulated more than $2 million in earnings and profits in Basin prior to the reorganization.

The hypothetical redemption approach also unnecessarily introduces an additional speculative inquiry into the Section 356(a)(2) analysis. This case is an unusual one in that respondent was offered a choice between two different transactions—a pure stock-for-stock reorganization or one involving boot. Hence, it was relatively easy to construct a hypothetical redemption scenario; it was based on the stock-for-stock option that respondent rejected.[20] But in cases that lack this unusual aspect the hypothetical redemption scenario may require considerable speculation and guesswork. The court of appeals' approach requires a court to determine how many shares would have been exchanged if the reorganization had not involved boot, but instead had been purely stock-for-stock. That determination is critical because the application of the Section 302 "safe harbor" turns on the number of shares that hypothetically would have been received instead of the boot and then redeemed. Determining that number of hypothetical shares can require a difficult and complex inquiry. It involves problems not only of valuing the stock in market terms but also assessing the extent to which the valuation is affected by shifting control, factors that become particularly elusive in the case of closely-held corporations.[21]

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[20] Even on these facts, the hypothetical redemption analysis involves some speculation. The court of appeals' analysis assumes that respondent would have redeemed 125,000 shares for $3,250,000, apparently based on a price of $26 per share. Had he redeemed that number of shares at the market price on the date of the reorganization, $23⅛ per share (see J.A. 28), he would have received only $2,890,625 upon the redemption.

[21] The imprecision inherent in making this speculative determination is significant here because of the "either-or" nature of the inquiry. In many tax controversies involving a valuation problem, a small variation in valuing property will yield a correspondingly small variation in tax consequences. Here, however, a small variation in the number of shares assigned to the hypothetical redemption can change the resolution of the ultimate issue—whether the entire boot distribution should be treated as having the effect of a dividend.

3. Finally, the court of appeals' hypothetical redemption approach fails to comport with the terms of the statute. As we have shown, the boot distribution in this case had "the effect of the distribution of a dividend" by Basin. The court of appeals never disputes that conclusion. Instead, it chooses to analogize the boot distribution to another transaction, the hypothetical stock-for-stock reorganization followed by a partial redemption. The most that can fairly be said for the court of appeals' suggested analogy is that it attempts to show that the boot distribution might also have the effect of a transaction that would not be a dividend. But, of course, that is not the test that is set forth in Section 356(a)(2). The statute says that a boot distribution that has "the effect of the distribution of a dividend" should be treated as a dividend to the extent of earnings and profits; if that condition is satisfied, there is no statutory basis for deviating from that treatment simply because the distribution also has the effect of a different kind of transaction that would not qualify as a dividend.

In any event, it is not correct to say that the boot distribution here has the effect of the redemption hypothesized by the court of appeals. There is, of course, a superficial similarity between the two transactions in that respondent ends up, before taxes, with the same amount of cash and stock at the end of both. But there are also major differences between the two transactions with respect to the basic tax accounts that are generated, and these differences vitiate any suggestion that the hypo-

thetical redemption can be equated with the boot distribution.

First, the basis of each of the NL shares received by respondent in the reorganization is different in the two transactions. The total basis of those shares is transferred from respondent's basis in the Basin stock he gave in exchange (I.R.C. § 358(a)), and that total basis must be allocated over the total number of shares received. Thus, the basis of each individual share obviously would be different depending upon whether the total basis is allocated over the 300,000 shares received in the actual merger or over the 425,000 shares that would have been received in the transaction hypothesized by the court of appeals.[22] Second, because the gain recognized on a redemption that is not essentially equivalent to a dividend is reduced by the basis of the redeemed shares (I.R.C. §§ 302(a), 1001(a)), the gain recognized in the hypothetical transaction would have been different from the $3,250,000 that respondent acknowledged in the Tax Court had to be recognized on the actual transaction involving boot.[23]

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[22] On the facts of the actual transaction here, respondent's basis in each of the 300,000 shares he received was $0.3651. Had he received 425,000 shares as hypothesized by the court of appeals, his basis in each share would have been $0.2577.

[23] Because respondent's basis in his Basin shares was so low, this difference in the amount of gain under the two transactions is relatively small in this case ($3,217,787.50 vs. $3,250,000). But the difference could equally as well be quite significant under another set of facts. For example, suppose respondent's basis in his Basin shares had been $4,250,000. Under the hypothetical scenario of the court of appeals, each of the 425,000 NL shares received by respondent in the exchange would then have had a basis of $10. When he redeemed 125,000 of those shares for $3,250,000, the resulting gain would be only $2,000,000. Applying Section 356(a)(1) to the actual reorganization, however, would still yield a taxable gain of $3,250,000.

Another difference between the two transactions is the effect on the earnings and profits accounts. In the actual transaction, the earnings and profits available for distribution as a dividend were Basin's $2,319,611 in accumulated earnings and profits. The gain recognized upon the boot distribution would have been applied against that account. That reflects the basic theory of Section 356(a)(2)—that the shareholders of the corporation who receive a pro rata distribution of boot are withdrawing earnings and profits from the reorganization, subject to the limitations of the amount of their recognized gain and ratable share of earnings and profits. If respondent had chosen the redemption option, on the other hand, the gain would have been applied against and reduced the earnings and profits of NL (a figure that is not in the record here and that, in any event, bears no relation to Basin's or respondent's history). Basin's earnings and profits would have remained intact and been carried over into NLAC, the subsidiary. Thus, the effect on the continuing earnings and profits accounts would be substantially different under the two transactions.

In sum, it cannot be said that the boot distribution that actually occurred here had the same effect as a hypothetical redemption following a pure stock-for-stock reorganization. It remains true, however, that the pro rata boot distribution did have the same effect as a dividend distribution by Basin. Accordingly, Section 356(a)(2) requires that the boot be treated as a dividend to the extent of Basin's undistributed earnings and profits.

CONCLUSION

The judgment of the court of appeals should be reversed.
Respectfully submitted.

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APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as amended, provides in pertinent part:

SEC. 301. DISTRIBUTIONS OF PROPERTY

(a) *In general*

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount taxable*

In the case of a distribution to which subsection (a) applies –

(1) *Amount constituting dividend*

That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis*

That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis*

(A) *In general*

Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) *Distributions out of increase in value accrued before March 1, 1913*

That portion of the distribution which is not a dividend, to the extent that it exceeds the ad-

justed basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

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SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK

(a) *General rule*

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions treated as exchanges*

(1) *Redemptions not equivalent to dividends*

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock*

(A) *In general*

Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation*

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions*

For purposes of this paragraph, the distribution is substantially disproportionate if –

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of –

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions*

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest*

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Redemption from noncorporate shareholder in partial liquidation*

Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) Application of paragraphs

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

* * * * *

SEC. 316. DIVIDEND DEFINED

(a) *General rule*

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SEC. 317. OTHER DEFINITIONS

(a) *Property*

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock*

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS

(a) *General rule*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(3) *Cross references*

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

* * * * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION

(a) *Gain on exchanges*

(1) *Recognition of gain*

If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend*

If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

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